November 11, 2015

Decreasing Correlations and Our Investment in Envestnet, Inc.

At the end of last quarter, we called the market selloff “a liquidation move.”[1] During October, stocks recovered much of their losses from the prior few months. This is often how a bounce back from liquidation selling transpires. Once the forced seller stops, markets recover. While October was a strong month, it’s important to caveat that when markets move really fast in a short period of time, they inevitably require a breather. It would be healthy to see some digestion here with more volatility compression. Further, we remain in an environment where some individual stocks are getting thrown out of the window on bad news. We need to see a stop to the number of stocks with large hedge fund ownership dropping 15+% in one-day moves before a healthy, broad-based uptrend resumes. So long as this kind of carnage is out there, funds will have to continue reducing gross exposure, thus creating a headwind for markets.

One consequence of the recent market action has been a sharp drop in implied correlation as evidenced by the CBOE S&P 500 Implied Correlation Index (source, Bloomberg):

[1] http://www.rgaia.com/a-liquidation-move/

Here's the description of the index from CBOE:

> Using SPX options prices, together with the prices of options on the 50 largest stocks in the S&P 500 Index, the CBOE S&P 500 Implied Correlation Indexes offers insight into the relative cost of SPX options compared to the price of options on individual stocks that comprise the S&P 500.[2]

When this index is rising (falling), it means that correlations amongst the 50 largest S&P stocks are rising (falling). In other words, the higher this index, the more in unison stocks move, and the lower the index, the more stocks move independently of each other. There's a saying that "all correlations go to 1 in a crisis," which means that everything tends to move in unison when things are bad. A drop in correlations, as we're seeing now, is just another healthy step towards putting the Great Financial Crisis in our rearview mirror. This is a phenomenon we have noticed in our portfolio and is something we believe should benefit us as time progresses. We long for a market where individual securities perform based on merit as opposed to knee-jerk market reactions to macro headlines or index-driven fund flows.

A new stock in your portfolio:

During the month of October we commenced a new position that we are excited to share: Envestnet Inc. Envestnet has two main business lines, each with outstanding business models, catering to the growing Registered Investment Advisor (RIA) landscape. The main business at Envestnet is the asset-based fee segment (the "AUM/A business"). The second is a software licensing business. Collectively Envestnet provides one of the most robust back-end technologies for investment advisors, one of the fastest growing segments of the financial services industry. We'll focus most of the following conversation on the AUM/A business.

Envestnet's AUM/A business allows financial advisors and asset allocators to connect with fund managers and specific investment strategies. Envestnet's software helps construct the allocations for advisors based on each individual client's needs, after which the advisor can use some of Envestnet's own solutions or external managers who offer their services through Envestnet's platform (this is a multi-sided network that works great for all parties). As of the end of the third quarter this year, AUM/A was at $250 billion, from which the company earned a fee of ~13.25 basis points. By our estimates, this fee has varied overtime from around 11.3 basis points up to 14, but has generally hovered around 12. We use 12 in our model.

[2] https://www.cboe.com/micro/impliedcorrelation/

There are three key traits we love about this business:

1) The AUM/A business tend to be very sticky and benefits from inertia. People don't frequently change the decisions they have made with respect to their advisor unless something goes very wrong.
2) The allocation of Envestnet's AUM/A is by nature very diverse. Considering much of these assets are in traditional "wealth management" the AUM/A viewed as a portfolio most closely approximates a 60/40 allocation between stocks and bonds. Plus there should be portfolio inflows equal to the average household savings rate. Taken together, as the company has explained, the growth in AUM/A should be approximately three times the rate of inflation. Note that this is purely the intrinsic growth of the asset business itself, not the growth that Envestnet can tap into from expanding the number of advisors who use its platform.
3) In aggregate, the AUM/A is stylistically agnostic. There are all kinds of managers on Envestnet. If a style like "momentum" is replaced with "value" in popularity, Envestnet will capture this transition.

Beyond these natural drivers of stickiness and growth, we think Envestnet has a major runway for future growth. There are three key leverage points that we focus on:

1) Growth in advisors on the Envestnet platform
2) Growth in accounts per advisor
3) Growth in dollar value per account (which relates to point 2 above)

The Great Financial Crisis and changing regulatory landscape have helped accelerate the investment management industry's transformation from the broker / dealer (b/d) model that made money off of commissions to the fee-based, independent model that makes money off of a small percentage of assets under management. Importantly, the pivot from the b/d model to the RIA platform has also come with the growth of a fiduciary standard, whereby managers must put themselves in the shoes of their clients when making decisions (as an aside, it is shocking how resistant wealth managers at b/ds are to the idea of a fiduciary standard. Do they not think it natural for to expect their own interests to be tantamount to the advisor's generation of fees?).

In a Cerulli Associates study of the asset management landscape, they presented the following information on recent growth of the RIA platform:

> RIAs experienced the strongest growth among the independent channels in 2013. According to Cerulli, the channel increased 17.1% in 2013 to $1.67 trillion in total assets and expanded its asset

> marketshare from 9.2% in 2007 to 11.9% in 2013, which equates to a compound annual growth rate of 8.3% and a $600 billion boost in assets on a base of $1 trillion.[3]

We are thankful to have played our small part in the existence of this trend and expect it to continue indefinitely into the future. We like that no matter which way you slice it assets of advisors who use Envestnet's platform; RIAs; or, RIAs + broker/dealers, Envestnet has captured a mere hair of the total addressable market.

In addition to fee-based revenue, Envestnet also sells a software platform called Envestnet Tamarac, a direct competitor to the Black Diamond platform you are all now familiar with. We can speak a lot from the customer perspective of the relative merits of Tamarac vs Black Diamond. Nevertheless, we think Tamarac is an outstanding product, which benefits from its own kind of stickiness and a long runway of growth. Advent, the parent company of Black Diamond, recently sold for 18x EV/2015 estimated EBITDA. This juicy multiple is reflective of the high margin nature of these businesses, the extended pipeline of growth, and the stickiness of existing customers.

The AUM/A and licensingbusinesses have another common trait we have yet to mention: very little capital intensity. Neither of these businesses need to invest significant capital expenditures to grow, and both of them do most of their "investing" in the form of R&D and scaling headcount, which flow through operating expenses. These operating expenses are not capitalized, despite the fact that the costs actually produce material benefits for years down the line. This is one of the key reasons we expect operating leverage out of Envestnet each subsequent year alongside its robust top line growth.

All this begs the question as to why Envestnet is cheap. In the short-run, the company is sensitive to asset prices. When markets decline as they did in the third quarter, it is a headwind to Envestnet achieving their growth targets. The third quarter's decline will be most visible in the company's fourth quarter earnings report and investors were anticipating this pain. Most consequentially, Envestnet announced it will be acquiring Yodlee, a financial account aggregation and data service.[4] Alongside the acquisition, Envestnet indicated that organic growth would not reach the 20% annualized top line the company had hoped for, but rather settle in the high teens. This dual-shock amidst the intense August volatility sent the stock tumbling. It didn't help that Envestnet made the acquisition in-part with stock, thus incentivizing merger arb funds to sell Envestnet while buying Yodlee.

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[3] http://www.thinkadvisor.com/2014/12/19/ria-dually-registered-assets-to-reach-28-market-sh

[4] http://www.envestnet.com/press/envestnet-acquire-yodlee

In our estimation, Envestnet had been aggressively valued earlier in the year, and as so often happens, the correction "overshot" past fair value into the domain of cheapness. Just this past year the company hit the point in its growth curve where revenues flow through at a greater rate to bottom line profitability. Right now it is trading at around a 10x EV/2017 estimated EBITDA with top line continuing to grow at upwards of 15% and EBITDA growing at least 5% greater than the top line. In our model, we focused on what core Envestnet was worth pre-Yodlee acquisition. We see the top line compounding in the high teens, generating an extra 150 BPS of operating leverage per year and a 3% terminal growth rate, which results in a fair value of $40. Given that this analysis excludes Yodlee's revenue and earnings contribution, but includes the cost of the acquisition (and given that we underplay the growth and operating leverage inherent to the business model), the price today around $30 looks incredibly attractive. This kind of growth is hard to find in any sector where the business quality is so outstanding and sticky for the long-term and the operating leverage so obvious and imminent. It is exceedingly rare to find such a company at this modest a multiple given the evidence of quality and growth. With these kinds of properties, we look forward to Envestnet being a core holding for the long run.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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